

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Robert Pacheco Analyst: Gloria McConnell Bill Number: AB 965

Related Bills: _____ Telephone: 845-4336 Introduced Date: 02/25/99

Attorney: Doug Powers Sponsor: _____

SUBJECT: Foreign Market Opportunities Expansion Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (BCTL), a qualified taxpayer, as defined, would be allowed a credit of 5% of the net increase in revenue derived during the taxable/income year for the expansion of foreign market opportunities, as defined.

EFFECTIVE DATE

The credit would apply to taxable or income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business to arrive at net or taxable income (BCTL and PITL, respectively). In addition, depreciation of capital assets used in a trade or business is deductible in arriving at net or taxable income. California law also allows a variety of credits against tax.

This bill would allow a credit to a qualified taxpayer in the amount equal to 5% of the net increase in revenue derived during the year by a qualified taxpayer from the qualified taxpayer's expansion of foreign market opportunities.

A "qualified taxpayer" would mean a person or entity engaged in a trade or business with gross receipts of less than \$50 million during the taxable year for which the credit is claimed.

"Expansion of foreign market opportunities" would mean that the person or entity has exported goods or services to a foreign market with which the person or entity "has not previously traded" or has increased the flow of goods or services to an existing foreign market.

This bill would provide an indefinite carry forward of any excess credit.

Since the bill does not specify otherwise, this credit would not reduce regular tax below tentative minimum tax.

Policy Considerations

This bill raises the following policy considerations:

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald Goldberg

4/14/1999

- The subject and Sections 1 and 2 of the bill focus on technology development, related service industries and the exporting thereof. However, the tax credit is not limited to these fields; it would apply to any industry or type of goods or services.
- This bill would provide a credit for exports made pursuant to a binding contract entered into before this bill was introduced or enacted, thereby acting to some extent as a reward for past behavior rather than an incentive for future behavior.
- This bill would provide a credit based on an increase in revenue. Typically, under current law credits are based on a percentage of an amount paid or incurred. By basing the credit on revenue, an increase could result merely from inflation or the U.S. dollar devaluation.
- The credit is not limited to the exporting or flowing of goods or services solely from California. For example, a corporation headquartered in New York, but doing some business in California (a California taxpayer) could increase exports from its New York operations and generate a California tax credit to offset its tax liability in California from income unrelated to the increased export activity. In addition, it is unclear whether the goods or services that are exported must originate, be manufactured or be performed in California, in whole or in part. However, limiting the application of the bill to address those issues in turn raises Constitutional problems with the bill. Accordingly, a method of apportioning the credit might be considered.
- By providing a \$50 million cap on gross receipts, the credit appears to be targeted for smaller businesses. If that is the goal, the bill should clarify that the gross receipts test would apply to the combined unitary group, in total, rather than each member/subsidiary.
- This bill does not specify a repeal date or limit the number of years for the carryover. Credits are typically enacted with a repeal date to ensure that the Legislature reviews its effectiveness. Also, credits are typically used within eight years of being earned. Recent credits have been enacted with a carryover limit so the department is not required to retain the credit carryover on the tax forms indefinitely after its repeal date.

Implementation Considerations

This bill would be problematic to implement because of the following considerations. Upon request, staff will work with the author's office to resolve these issues.

- The terms "net increase" and "revenue," on which the credit is based, are not defined. No rules or guidelines are provided for determining revenue. It is unclear if the net increase is in comparison to the prior year's revenue. Additionally, it is unclear if a new company, with no prior sales activity, could qualify all revenue for the credit.

- The term "export" is not defined. It is unclear if a foreign customer who comes to California to purchase goods and then sells the goods within California would qualify for the credit.
- The phrase "has not previously traded" is not defined. It is unclear if a foreign customer that reorganized would be considered "not previously traded with." It is unclear if a taxpayer that merely changes distributors/customers and actually decreases exports would qualify for the credit. Additionally, without a time frame on which to measure "previously traded," the taxpayer's records back to the beginning of the taxpayer's business could be subject to audit.

Technical Considerations

- According to the author's office, "foreign" is intended to mean outside the United States and its territories. However, unless clarified, "foreign" could be misinterpreted to mean merely outside California.
- The credit would be limited to all taxpayers who have less than \$50 million in gross receipts during the year (page 4, line 39 and page 5, line 23). To avoid disputes between the taxpayer and the department, the gross receipts test should be tied to a fixed date, such as the end of the taxable/income year.
- The phrase "person or entity" should be omitted in defining "qualified taxpayer" (page 4, line 37). The use of the phrase "person or entity" in this context is unnecessary and may cause confusion. Instead, the term "taxpayer," a term defined in RTC Sections 17004 and 23037, should be used.
- Most provisions of the Revenue and Taxation Code that measure qualification based upon "gross receipts" reduce that amount by "returns and allowances." The author may wish to use the same formulation to avoid confusion with other such provisions.

FISCAL IMPACT

Departmental Costs

Departmental costs cannot be determined until the implementation considerations have been resolved.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, order of magnitude revenue losses under the Personal Income Tax Law and the Bank and Corporation Tax Law are projected as follows:

Beginning on or after January 1, 1999 Enactment after June 30, 1999 (in millions)		
1999-0	2000-1	2001-2
\$270	\$340	\$360

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

In deriving order of magnitude revenue impacts for this bill, the following assumptions were made: (1) for a combined unitary group, the gross income test would apply to the group in total rather than the member/subsidiary in isolation of the group; (2) "foreign" means countries outside the U.S.; and (3) since "net increase in revenue" is undefined, it would be equivalent to one-third of exports of qualifying businesses.

The above estimates were based on State of Manufacture and Origin Data from the U.S. Census Bureau, Foreign Trade Division as reported by Massachusetts Institute for Social and Economic Research. These data indicate that for 1998 the value of exports by California businesses was \$105 billion. Based on data from Department of Commerce, it is estimated that the firms with gross receipts of less than \$50 million account for approximately 30% of exports. Consequently, it is projected that approximately \$30 billion in annual exports would come from qualified taxpayers, of which perhaps one-third (\$10 billion) could be qualified under the broad definition of the bill (net increase in revenue for new or expanded markets) for the 5% credit (\$10 billion in exports potentially qualifying x 5% credit x 50% reduction due to insufficient tax liabilities x 1.07 growth = \$264 million for 1999). Significant increases in revenue losses will occur in subsequent years due to unused carryover credits and growing world demand for U.S. goods and services, including new technologies.

BOARD POSITION

Pending.